American Jobs Creation Act of 2004 - Highlights Regarding the Manufacturing Deduction and Temporary Repatriation Deduction

The impetus for the American Jobs Creation Act of 2004 ("Jobs Act") was the need to repeal the export subsidies that had been found to be in violation of World Trade Organization ("WTO" agreements. The violations had provoked the European Union ("EU") to impose tariffs on U.S. companies. However, the Jobs Act not only repeals the export subsidies, but creates a plethora of tax incentives and revenue offsets across the board, applying to individuals and businesses.

Extraterritorial Income ("ETI") repeal

The United States has provided export-related benefits under the tax code for years. It began with the foreign sales corporation ("FSC") regime which provided reduced tax rates on certain foreign trading income to allow such companies to become more competitive in the international marketplace. In 2000, the EU succeeded in having the FSC regime declared a prohibited export subsidy by the WTO. The United States repealed the FSC regime and enacted the ETI regime. Under the ETI regime, "extraterritorial" income is excluded from gross income attributable to "foreign trading gross receipts" with some limitation. The EU challenged the ETI regime and the WTO declared that the ETI regime also constituted a prohibited export subsidy.

The Jobs Act repeals the ETI exclusion. The repeal is effective for transactions occurring after Dec. 31, 2004, except for transition relief. Under the transition rules: (1) the ETI exclusion continues to apply to transactions in the ordinary course of business that are pursuant to a binding contract that was in effect on Sept.17, 2003, and at all times thereafter; and (2) taxpayers are provided with 80% of their otherwise-applicable ETI benefits during 2005 and 60% of their otherwise-applicable ETI benefits during 2006.

New deduction for U.S. production activities

Congress intended to repeal the ETI regime to comply with the WTO, however, keeping U.S. manufacturers competitive internationally was still a concern. The Jobs Act replaces ETI with a new tax deduction for domestic production activities. The deduction is a percentage of the net income from those activities—3% in 2005-2006, 6% for 2007-2009, 9% after 2009. When fully phased in, the deduction is designed to be economically equivalent to a 3% reduction in the tax rate on U.S.-based production activities. The amount of the deduction for any tax year may not exceed 50% of the employer's W-2 wages for that tax year. The deduction is available to all taxpayers with qualified production activities income, and it is allowable in computing AMT income.

This new deduction is export neutral, therefore, it hopefully will escape the EU's previous concerns. All U.S. manufacturers will benefit rather than only multinationals. The deduction is applicable to not only C corporations, but also S corporations, partnerships, and other small businesses. However, the deduction may have limited opportunities for businesses that are not C corporations due to the limitation of 50% of the employer's W-2 wages. For example, guaranteed payments in partnerships and distributive shares in limited liability companies are not considered wages for W-2 purposes. In addition, bottom line Schedule C amounts for sole proprietors are not considered wages.

The U.S. production activities deduction is allowed with respect to a taxpayer's qualified production activities income, which is the taxpayer's domestic production gross receipts net of expenses.

“Domestic production gross receipts” are receipts derived from any of the following:

- Any lease, rental, license, sale, exchange, or other disposition of—
- qualifying production property (i.e., tangible personal property, any computer software, and certain sound recordings) that was manufactured, produced, grown, or extracted in whole or in significant part by the taxpayer within the U.S.;
- any qualified film produced by the taxpayer; or
- electricity, natural gas, and potable water produced by the taxpayer in the U.S.
- Construction performed in the U.S.
- Engineering and architectural services performed in the U.S. for construction projects in the U.S.

For pass-thru entities (such as S corporations, partnerships, estates and trusts), the deduction generally is determined at the shareholder, partner or similar level by taking into account at that level the proportional share of the qualified production activities income of the entity.

Since expense allocations will become critical in tax planning, transfer pricing issues that previous did not affect domestic corporations that were part of a consolidated group, will now affect almost every type of organization. Arm's length allocations and pricing will be the norm for most taxpayers in order to maximize the benefits of this deduction.

The deduction applies more broadly than simply to manufacturers. Construction, engineering and architectural firms, as well as software companies and electric, gas and water companies will also benefit.

Repatriation of foreign earnings to the United States

Finally, Congress attempted to create an incentive for companies to repatriate earnings to the U.S. As mentioned above, the FSC and ETI regimes caused major outflow of cash offshore. Now Congress wants some of that cash invested here. The Jobs Act allows a temporary elective 85% dividends received deduction for cash dividends received by a corporation that is a U.S. shareholder of a CFC for tax years ending on or after Oct. 22, 2004, subject to a special election. The cash must be invested in the U.S. under a properly approved domestic reinvestment plan. The domestic reinvestment plan does not simply mean job creation but also applies to purchasing infrastructure, R&D, capital investments and financial stability of the corporation. The window to elect this benefit is only one year – so taxpayers should act quickly to take advantage of this incentive.